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Taxation of carried interest under the DTA between the USA and Germany

The right to tax carried interest (i.e. the additional share of profits disproportionate to the capital invested) is vested in the country of residence either under Art. 21(1) Double Tax Agreement-USA (“DTA-USA”) (Other Income) or under Art. 13(5) DTA-USA (Capital Gains) if the corresponding income constitutes income from asset management and not income from business activities. In a recent decision, the Schleswig-Holstein Tax Court ruled on the treaty qualification of the carried interest received by a German resident shareholder (the intervenor) of a limited liability company established under the law of the US state of Delaware with its registered office and place of management in the US (the claimant).

Facts

The claimant's business was mainly investing in other entities whose business was mainly buying, holding, and selling shares in corporations.

The claimant was owned exclusively by natural persons who, between 2006 and 2011, were resident partly in the United States and partly in Germany and were considered resident there under the DTA. The intervenor was a German citizen and was one of the shareholders who was resident in Germany and – undisputed between the parties – considered resident there under the DTA.

The proportional share of profits between the claimant and the intervenor was undisputed between the parties. In addition, the claimant received an advance profit payment (hereinafter referred to as ‘additional profit share’ or ‘carried interest’) from the participating companies. The claimant received carried interest for its non-material role in promoting the company, especially by identifying investment opportunities for the funds. This non-material contribution was in fact made by the claimant's shareholders, who were therefore entitled to a share of the carried interest. The amount of their share was based on the scope and significance of the respective contribution of the shareholders to the claimant's non-material contribution to the participating companies.

The partnership agreement provided for a profit distribution agreement and not remuneration for activities with the grant of an additional profit share (undisputed between the parties). In the opinion of the parties involved, the claimant was a partnership from a German tax perspective according to the relevant comparison of legal types. From a German tax perspective, the claimant was also – according to the undisputed opinion of the parties involved – merely engaged in asset management and not in commercial activities. It was also undisputed between the parties that the intervenor, as a German resident shareholder, had in fact only provided his non-financial contribution whilst in the USA. Since his return to Germany in 2006, neither the claimant nor the intervenor had maintained a permanent establishment in Germany. In the appeal proceedings for 2011, the claimant and the intervenor waived any possible credit or deduction of foreign tax. The amount of the claimant's total income and the distribution of profits among the individual shareholders was undisputed between the parties. The claimant was of the opinion that the additional share of profits fell under Art. 7(7) of the DTA (Business Profits) with the USA, with the result that the USA was entitled to tax the income and that the income was

tax-exempt in Germany under Article 23(3)(a) of the DTA (Relief from Double Taxation) and was only to be taken into account within the scope of the progression clause.

Decision

The Schleswig-Holstein Tax Court did not follow this line of reasoning; it dismissed the action.

The court took the view that although the income from the carried interest was deemed self-employed income under Section 18(1)(4) of the German Income Tax Act (ITA), this domestic fiction did not extend to treaty law in such a way that would mean that this income would constitute ‘business profits’ within the meaning of Art. 7 para. 1, para. 7 DBA-USA.

The carried interest is in origin income derived from capital assets (see Supreme Tax Court case of 16 April 2024 VIII R 3/21, BStBl II 2024, 902). The principles established by case law on income with ‘commercial character’ pursuant to Section 15(3) of the German Income Tax Act (ITA) (cf. Supreme Tax Court ruling of 28 April 2010, BFH I R 81/09, BFH 229, 252, BStBl II 2014, 754) are also applicable to self-employed activities pursuant to Section 18(1)(4) ITA.

The right to tax income from the carried interest therefore lies with the country of residence – in this case Germany – either pursuant to Art. 21(1) of the DTA with the USA or pursuant to Art. 13(5) of the DTA with the USA.

Reference

Schleswig-Holstein Finance Court, judgment of 8 October 2024 (3 K 37/22), see the Finance Court's newsletter 1/2025; the appeal is pending before the Supreme Tax Court under case number I R 24/24.

Schlagwörter

International Tax, business income, double tax treaty, partnership income